NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Second Quarter of 2004 through the Fourth Quarter of 2007

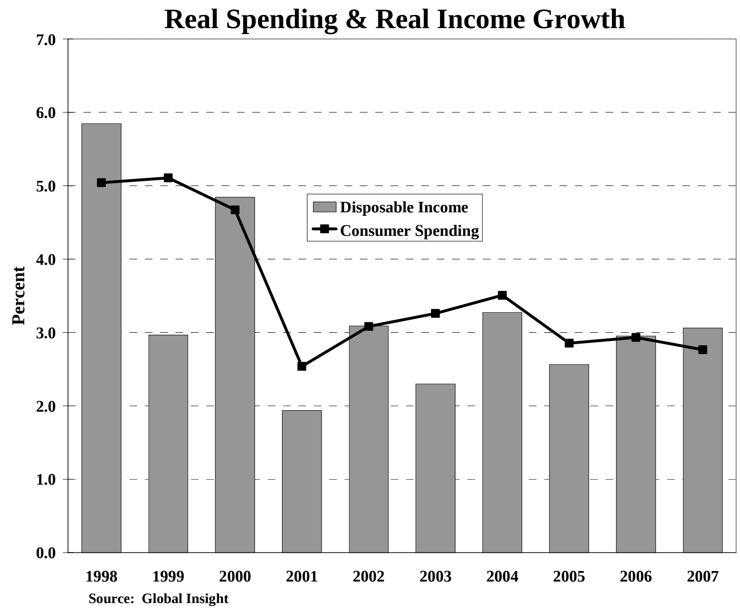
The outlook for the national economy has been lowered compared to the previous forecast. In the July 2004 *Idaho Economic Forecast*, it was reported U.S. real GDP would grow a healthy 4.9% this year, 3.8% next year, 2.9% in 2006, and 3.4% in 2007. In the current *Forecast*, real output advances 4.3% in 2004, 3.3% in 2005, 2.9% in 2006, and 3.2% in 2007. Other key measures are also expected to perform below their previously forecasted counterparts. For example, U.S. real personal income was anticipated to expand 3.6% annually in the prior *Forecast*. It is projected to rise just 3.2% per year in the current *Forecast*. Nonfarm employment displays a similar change. This much-watched measure of the nation's economic health is forecast to grow an average of 1.2% annually. While this is stronger performance than in the last few years, it is below the previously forecasted rate of 1.4%. The slower projected growth rate translates into nearly 1.5 million fewer jobs in 2007 compared to the previous *Forecast*.

The differences between the previous and current forecasts largely reflect different assumptions about oil prices. In the previous *Forecast* it was believed the price of oil was near or just passed its peak and would soon retreat. Specifically, the spot price of West Texas Intermediate crude oil would average $38.08 per barrel, but fall to $28.00 per barrel by 2007. Unfortunately, this forecast was made before prices ran over $50 per barrel this summer and fall. What seemed impossible a few months before became reality and forced analysts to rethink their forecasts. Instead of a relatively shallow peak and steep price decline, the current forecast shows a higher peak and shallower decline. Namely, the spot price for West Texas Intermediate crude oil is just over $40 per barrel this year and gradually falls to about $35 per barrel in 2007. At these prices, the impact on the economy becomes noticeable, but not devastating.

It has been estimated the increase in oil prices, both actual and projected, since the year's beginning has shaved about 0.3-0.4% off GDP this year and about 0.7-0.8% off GDP next year. Sectors that will be particularly hard hit by high oil prices include airlines, other transportation services, utilities, the chemical industry, and heavy manufacturing. Higher oil prices have caused energy-related inflation to soar at an estimated 26.3% annual rate in the second quarter of 2004. Should increases of this magnitude spread to overall inflation, it would have a destabilizing effect on the economy. Fortunately, the impact of rising oil prices have for the most part been restricted to the energy component of consumer prices. For example, overall inflation rose at a 4.7% rate in the second quarter of this year even as energy prices soared. Even with the second quarter spike, consumer prices are expected to grow just 2.6% in 2004, followed by 1.9% in 2005, 1.5% in 2006, and 1.7% in 2007.

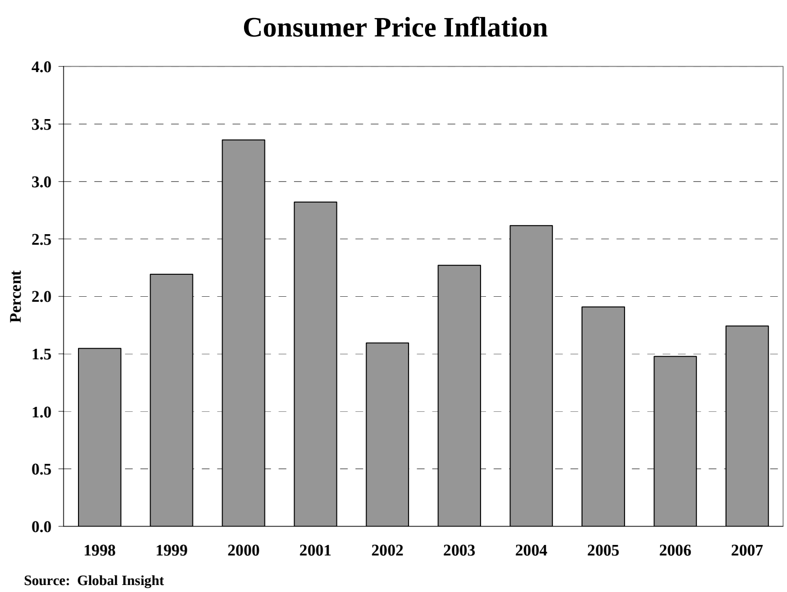
The anticipated low-inflation environment of the next few years is important because it will provide the Federal Reserve with enough leeway to carry out its policy. Faced with similar oil price shocks in a high-inflation environment, the "Volcker Fed" took drastic actions that caused the federal funds rate to climb to about 18% in early 1981. Chairman Greenspan recently testified he was not alarmed about oil prices, and this is reflected in the assumed central bank policy in this forecast. Specifically, the Federal Reserve is expected to raise rates in small increments. These moves are designed to gradually lift the real interest rate (interest rate less inflation) out of its current negative territory.

SELECTED NATIONAL ECONOMIC INDICATORS



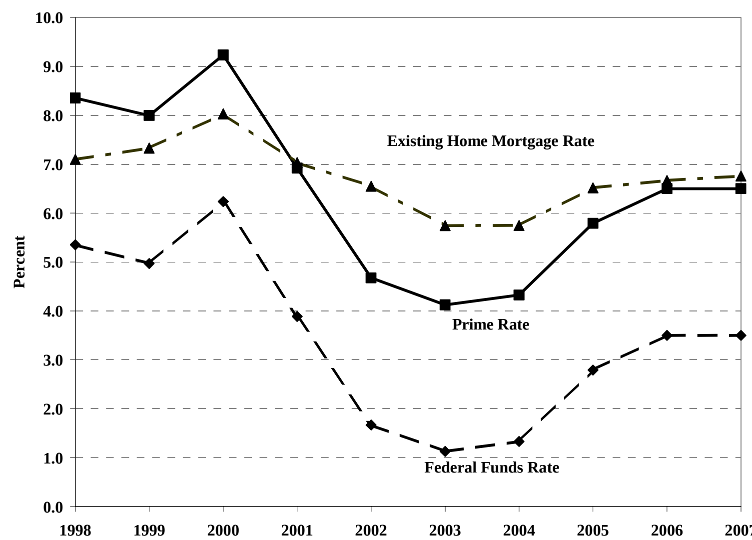
Consumer Spending: Consumer spending heated up this summer following a tepid showing last spring. Specifically, real consumer spending advanced at a nearly 4.0% annual rate during the third quarter of 2004, which more than twice as fast as it grew in the second quarter. Several factors contributed to this summer's hot performance. Big-ticket items were partly responsible. Closeout sales of light vehicles and the strong housing market enticed American consumers to once again open their wallets. Strong sales this summer also reflected ongoing strengths. Spending on computers, software, home furnishings, and health care continued to surge in the third quarter. And despite higher fuel costs, real spending on recreation and transportation services held steady this summer. The current consumer spending expansion began in early 1992. As it enters its adolescence, it is appropriate to wonder what lies ahead for consumer spending. Growth is expected to continue, but the most rapid growth spurts are behind us. Tax cuts that boosted disposable income growth for three years have ended. This forecast assumes parts of the 2003 income tax cuts that were due to expire in January 2005 will be extended. However, real disposable income will be impacted by effective personal income tax rates that are expected to drift up over the forecast horizon. However, it should pointed out that real disposable personal income will jump at a 7.8% annual rate in this year's last quarter thanks to the "Microsoft Dividend." Microsoft Corporation plans to pay a one-time $3.00 per share dividend on December 2, 2004. Although the amount per share may seem small, the overall impact should be huge, and provide a 0.2 percentage point kick to GDP in the fourth quarter. This estimate is based on the assumption that 6.25% of the total, or just over $2 billion, would be spent. Real disposable income is forecast to advance 3.3% in 2004, 2.6% in 2005, and about 3.0% annually from 2006 through 2008. Meanwhile, rising interest rates should cool housing markets, leading to moderate declines in home sales, new construction, and home improvement sales. As a result, spending on furniture, appliances, and other home goods will slow in 2005. Total real consumption growth is projected to slow from 3.5% this year to an average of 2.8% over the remaining years of the forecast. This spending forecast reflects the steady growth in employment and real wage income. One item that has been fairly constant during the spending expansion is the call for consumers to get their financial affairs in order. The personal savings rate was an often-sited measure of how bad consumers' portfolios had deteriorated. The savings rate had fluctuated around 10% from 1970 to 1984, but has fallen steadily over the past two decades. This year's projected rate of 1.2% marks an annual low. Unfortunately, it is expected to drop further over the forecast period. In the latter half of the 1990s, the low savings rate did not appear to be a severe problem because the stock market was doing the saving for households. This held until the stock market correction took place in 2000. Although aggregate household net worth has recovered from the losses it suffered from 2000 to 2002, it will be late 2008 before inflation-adjusted net worth per household fully recovers from the 18.7% hit it took between early 2000 and summer 2002.

Energy: One of the most significant changes from the previous forecast to the current one is the price of oil. To recap, in the July 2004 forecast it was assumed that the price of oil was close to cresting, and would decline to more sustainable levels. While this forecast may now seem optimistic, it was realistic at the time it was prepared. At that time the Saudis had agreed to ramp up production. The spot price of West Texas Intermediate crude had fallen below $40 per barrel and the prices for delivery six and 12 months out had fallen to the mid-$30s. However, this changed during the summer, as prices once again headed up. By this fall it was over $50 per barrel. As a result, it is assumed oil prices will remain high over the next few years. As a result, energy prices will be a drag on the economy. The recent surge in oil prices results from the confluence of fundamental shifts in petroleum markets and fears about supply disruptions. Since the acceleration of U.S. and global growth in mid-2003, demand for oil has grown much faster than supply, and this has pushed up prices. Compounding the fundamental oil market price pressures are fears over supply disruptions. These include attacks on Iraqi pipelines, political turmoil in Venezuela and Nigeria, and tax problems at Yukos, the Russian oil conglomerate. Unfortunately, oil market fundamentals also mean there is little relief in the next few years. The biggest problem is there is virtually no spare capacity in or outside OPEC. This current situation is the result of the dearth of investment in oil exploration and extraction during the mid-1990s. The good news is that high oil prices will eventually encourage investment in new capacity. The bad news is it will not happen overnight. Until then, any incremental oil supplies will come mainly from high-cost, remote, and politically unstable areas of the globe. As a result, oil prices are projected to remain high for an extended period of time. Specifically, the price per barrel of West Texas Intermediate crude is expected to stay above $40 for the rest of this year, fall to $39 per barrel in 2005, drop to $36 per barrel in 2006, and decline to about $35.00/barrel in 2007. It has been estimated the increase in oil prices, both actual and projected, since the year's beginning has shaved about 0.3-0.4% off GDP this year and about 0.7-0.8% off GDP next year. Sectors that will be particularly hard hit by high oil prices include airlines, other transportation services, utilities, the chemical industry, and heavy manufacturing.



Inflation: The run up in oil prices has had a surprisingly limited impact on overall inflation. Recent data show the energy sector has borne virtually the entire burden of surging oil prices. In the second quarter of this year, consumer prices in the energy sector soared at a 26.3% rate. During this same period, the core (all sectors except food and energy) inflation rate rose at a modest 3.0% annual rate. The overall inflation rate for the second quarter of 2004 was 4.7%. Over the forecast horizon, core inflation will continue to have more of an influence over total inflation, and this is good news. Core inflation is expected to drift higher over the near term due to rising labor costs. Rising labor costs reflect slower productivity growth. However, the upward drift in labor costs and, in turn, core inflation should not be a problem. Under these conditions the core inflation rate should be about 2.0%, which is fairly modest. Prices will also be held in check by competitive pressures. There is evidence this is already taking place. For example, finished goods prices actually fell recently even though prices at the intermediate level were rising. This suggests competitive pressures are forcing producers to absorb cost increases rather than pass them on to consumers. The anticipated decline in other commodities—metals, coal, lumber, chemicals, agricultural—should also help relieve inflationary pressures. Finally, oil prices are expected to fall gradually over the forecast period. As a result, overall consumer inflation should be below 2.0% during the most of the forecast period. Given the recent increase in its price, oil will remain one of the most closely watched economic indicators over the next few months. This begs the question: "What if oil price do not retreat?" This is a possibility. Early this year forecasters believed the oil price run up was over. However, this fall prices had climbed above $50 per barrel. A scenario has been prepared to explore the impact on inflation if oil prices remained higher than anticipated. The base forecast assumes the price of West Texas Intermediate crude slides from a high of $40.31 per barrel in 2004 to $34.14 per barrel in 2008. In the *Pessimistic Alternative Scenario* the price of oil falls, but more slowly. Under these conditions total consumer inflation would rise about 2.5% per year, compared to less than 2.0% annually when oil prices decline more steeply.

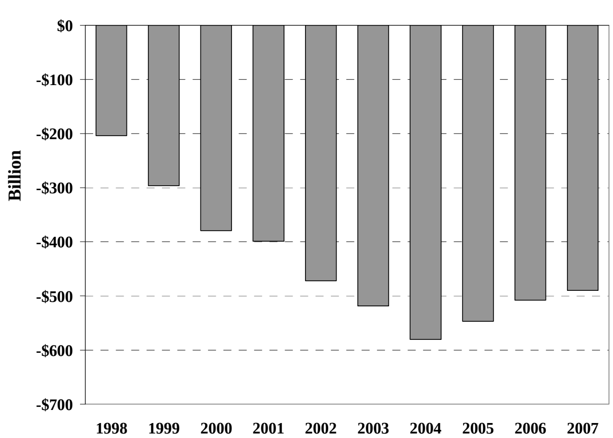
Selected Interest Rates



Source: Global Insight

Financial: Setting policy at the Federal Reserve, while never an easy task, became a bit harder recently due to stubbornly high oil prices and meager job growth. The nation's central bank began raising its bellwether federal funds rate 0.25 percentage point on June 30, 2004 in an attempt to normalize its rates from the ultra-low 1% level it reached at the trough of its recent cycle. This move was followed by 0.25 percentage point increases in August and September, bringing the rate up to 1.75%. Uncertainty about oil prices, along with slower economic growth, complicates the Federal Reserve's job. Higher oil prices could create a dilemma for the Federal Reserve by simultaneously worsening inflation and dampening economic growth prospects. So far the impacts of rising oil prices have been limited to energy costs. Indeed, core inflation has been remarkably benign, despite surging oil prices. This will buy the nation's central bank some policy latitude. However, while some policy doors have remained open others may close. September's disappointing labor report suggests the economic recovery may not be on as solid footing as had been previously thought. At the minimum, it makes it harder for the Federal Reserve to make the case for its current plan to gradually raise interest rates. If the economy is fragile and inflation is benign, what justification is there for raising rates? The current forecast assumes the Federal Open Market Committee will raise the federal funds rate by another 0.25 percentage point when it meets on November 10, 2004. Keep in mind, however, this assumption was made before the September 2004 labor market report was released. Before then it was a good bet the Federal Reserve would continue the policy it began in June 2004. Now there is a good chance the central bank may postpone its next increase until the labor market improves.

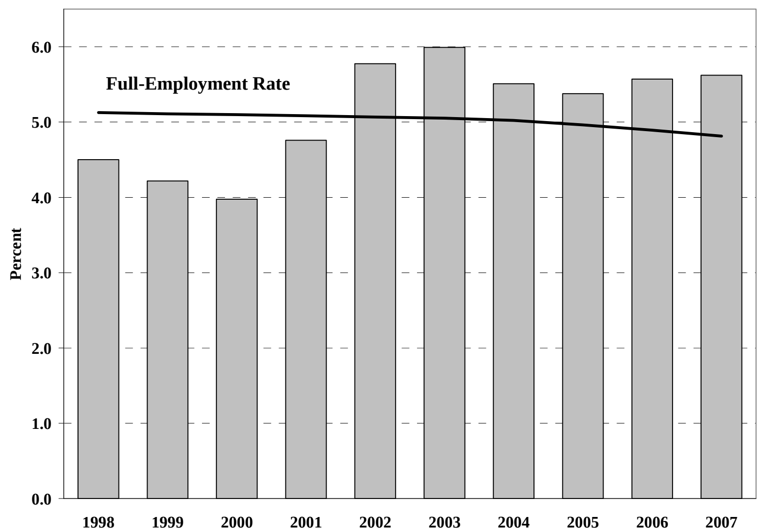
Real U.S. Trade Deficit



Source: Global Insight

International: The forecast for 2004 global economic growth remains above 4.0%, but some cracks are beginning to develop in the expansion. One obvious concern is high oil prices. Apart from high oil prices, other risks stem from the imbalanced nature of growth. The world continues to depend on the United States and China for a disproportionately large share of the expansion. The sharp deterioration of America's current account deficit in 2004's second quarter—plus weak domestic demand in the Eurozone and Japan—indicates the world is too dependent on the United States as a locomotive for economic growth. In the Eurozone, second-quarter growth came in at 2.1%. Unfortunately, almost all of it was driven by external demand. Specifically, domestic demand grew just 0.4%. The most recent news from Japan has also been disappointing. Second-quarter growth was revised down from the original estimate of 1.7% to 1.3%. As in the Eurozone, growth was led by the foreign sector; domestic demand barely budged from the first quarter. China remains a major concern. At this time, any signs of a slowdown are being welcomed because they decrease the risk of the economy over heating and suffering a hard landing in the future. The most recent data show no clear sign of cooling growth. This is a concern because it could lead to policy measures to reign in growth. The danger is any policy action runs the risk of being too heavy handed. This would slow growth abruptly, leaving The United States economy as the world's sole engine of economic growth.

U.S. Civilian Unemployment Rate

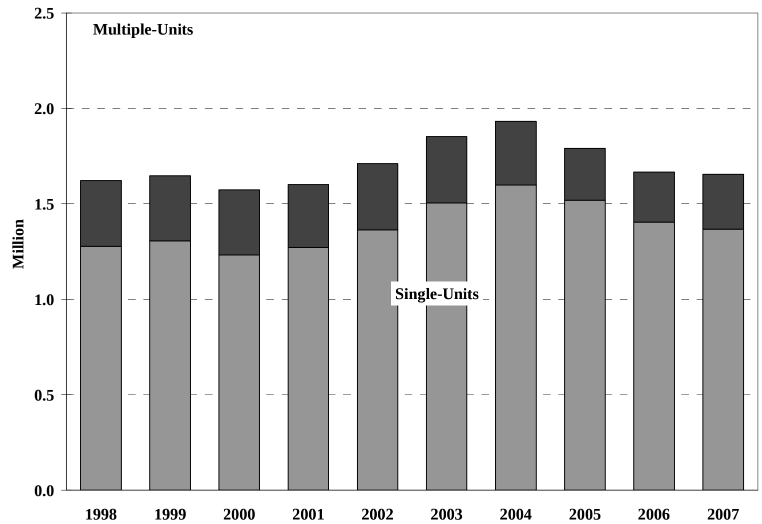


Source: Global Insight

Employment: Most of the attention regarding the labor market has focused on its disappointing performance in September 2004. Seasonally-adjusted nonfarm payroll employment was expected to rise 150,000 in that month. Instead, it rose by just 96,000 jobs—one of the year's weakest showings. Over the prior three months, payroll employment gained 103,000 jobs on average. All of September's job gains were in service sectors. The U.S. Department Labor has pointed out the unusual string of four hurricanes probably held down national employment in September. While the Department of Labor could precisely estimate the impact on jobs, it did state the impact was not big enough to materially impact the September 2004 payroll estimate. Not surprisingly, the September report has raised concerns the job recovery may be running out of fuel. Indeed, a close look at the data shows that after a strong start earlier this year, monthly job gains have become smaller. Specifically, there was a gain of 885,000 nonfarm jobs in March, April, and May of this year. Since May, payroll employment has risen by 405,000. One fear is if the job market gets too sluggish it will derail the recovery. This does not appear likely. Although recent job increases have been disappointing, they are still consistent with a clear rebound in this year's third quarter. Total hours worked in the private sector rose at a 3.2% annual rate in the third quarter—the strongest showing this decade. This acceleration in hours worked, combined with evidence of strong gains in consumption, construction, and business investment, support the view GDP accelerated to over 4.0% in the third quarter from 3.3% in the second quarter. In fact, real GDP is expected to increase over the forecast period. Nonfarm payroll employment in the U.S. is anticipated to advance 1.0% in 2004, 1.7% in 2005, 1.1% in 2006, 0.9% in 2007, and 0.7% in 2008.

Housing: This year will be a banner year for the housing industry. This can be seen in several measures of this sector's health. The number of total housing starts is expected to climb to nearly 2.0 million units this year—its strongest showing since 1978. Single housing starts should rise to nearly 1.6 million units, which is the all-time record. Given the robust housing starts, it is no wonder real spending on residential housing is expected to increase nearly 10% this year after advancing nearly 9% in 2003. These strong gains were due in large part to spending on single-family housing that grew even faster than total housing spending. The housing market's success is being fueled by several factors. These include relatively healthy income growth, recovering household finances, favorable demographics, and attractive mortgage interest rate rates. Inflation-adjusted disposable personal income growth accelerated from 2.3% in 2003 to an estimated 3.3% in 2004. Real household net worth improved 10.4% last year and 3.8% this year. New household formations grew 1.3% in 2004, which is slightly faster than the total population. Most notably, however, the conventional 30-year fixed mortgage interest rate has remained under 6.0% for two years in a row. Under these conditions the U.S. home ownership rate has soared to a four-decade high of 69.2% in the second quarter of 2004. The strong demand should increase an existing home's average price 8.9% in 2004 and a new homes price 9.8%. Ironically, strengths in some parts of the housing markets have caused weaknesses in other parts. For example, the affordability of single-family housing has been a boon to this sector, but has contributed to the expected declines in multi-family and manufactured homes in 2004. Although the housing industry's performances for just the last two years have been highlighted, it has been posting gains since 2001. Having set the bar so high, it will be challenging for the housing industry to continue its string of gains. In fact, this forecast assumes housing starts will decline over the forecast period. One fear is that having risen strongly, housing starts will collapse. This is not likely. Instead, housing starts are expected to decline gradually to just above its 2001-level over the forecast period.

U.S. Housing Starts



Source: Global Insight